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CITATIONS

Cases:

In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 678

JAMES G. NASH, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The findings of fact and conclusions of law of the district court (R. 12–13)[1] are not officially reported. The opinion of the court of appeals (R. 16–19) is reported at 414 F. 2d 627.

JURISDICTION

The judgments of the court of appeals were entered on July 2, 1969 (R. 20–22). The petition for a writ of certiorari was filed on September 30, 1969, and certiorari was granted on January 12, 1970 (R. 23). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

[1] "R." references are to the record appendix.

QUESTION PRESENTED

Whether a partnership's reserve for bad debts, representing income tax deductions allowed in prior years, should be restored to partnership income under the tax benefit rule upon the transfer of the partnership's accounts receivable to controlled corporations under Section 351 of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 166, 351 and 362 of the Internal Revenue Code of 1954 and Section 1.166-4 of the Treasury Regulations are set forth in the Appendix, *infra*, pp. 33–36.

STATEMENT

During 1960, petitioners[2] were members of a partnership operating eight finance organizations in Alabama and two in South Carolina. The partnership reported its income on the accrual method of accounting and used the reserve method of accounting for bad debts permitted by Section 166(c) of the Internal Revenue Code of 1954 and Treasury Regulations, Section 1.166-4. (R. 7.)

Under the reserve method of accounting for bad debts, a taxpayer includes in his income the full face amount of an account receivable upon its creation. He also maintains a reserve account, the balance of which is to be adjusted at the end of each taxable year so that it equals that portion of current accounts re-

[2] In addition to James G. Nash, petitioners are Cecelia Nash, who is a party solely by reason of the filing of a joint return; Birmingham Trust National Bank, as Trustee of the Margaret Nash Trust; and Birmingham Trust National Bank, as Trustee under the James G. Nash, Jr. Trust (R. 15–16).

ceivable which is reasonably estimated to become worthless in subsequent years. Any additions necessary to increase the reserve to its required level are currently deductible. When specific accounts receivable actually become worthless during the year, the reserve account is decreased and no additional bad debt deduction is allowed.

As of May 31, 1960, petitioners' partnership books reflected accounts receivable for the Alabama organizations of $486,853.69 and a reserve for bad debts of $73,028.05 (R. 7).[3]

On June 1, 1960, petitioners formed eight new corporations and transferred the assets of the eight Alabama organizations, including the accounts receivable, to these corporations in exchange for the latters' stock. The transfer was within the terms of Section 351 of the Internal Revenue Code, which provides that no gain or loss shall be recognized if property is transferred to a corporation in exchange for stock if, immediately after the exchange, the transferors possess at least 80 percent control of the corporation. (R. 7.)

Upon examination of the partnership return filed for the fiscal year ended January 31, 1961, the Commissioner determined that the partnership should have included in income the amount of the bad debt reserve ($73,028.05) applicable to the accounts receivable transferred to the corporations on June 1, 1960, because the partnership no longer had need of

[3] The exact amounts of the accounts receivable and reserves for bad debts of each of the eight Alabama oganizations are set forth in the stipulation of facts (R. 7–11).

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the reserve account. This adjustment in the partnership income led to an increase in the distributive shares of petitioners and resulting tax deficiencies for the calendar year 1961. (R. 11.)[4] Petitioners paid the deficiencies and brought suit in the district court after denial of their refund claims (R. 11).

The district court held that the amount of the outstanding reserve for bad debts did not have to be restored to petitioners' income as of the end of the partnership's fiscal year in which the transfer occurred (R. 12–13). On the government's appeal, the Fifth Circuit reversed (R. 16–19).

To resolve a square conflict of decisions between the Fifth and Ninth Circuits on this issue, this Court granted the taxpayers' petition for certiorari on January 12, 1970 (R. 23).

ARGUMENT

INTRODUCTION AND SUMMARY

Under the reserve method of accounting for bad debts, a taxpayer is permitted to take a current deduction for the amount of its accounts receivable which it is estimated will become worthless in subsequent taxable years.[5] The problem presented in this case is

[4] The deficiencies determined against petitioners were as follows (R. 11): James G. Nash and Cecelia Nash—$48,473.14; Birmingham Trust National Bank as Trustee for James G. Nash, Jr.—$1,042.96; and Birmingham Trust National Bank, as Trustee for Margaret Nash—$1,041.52.

[5] The reserve method is to be contrasted with the specific charge off method under which a deduction for bad debts is allowed only as and when a specific account becomes worthless. The use of either method is authorized in Section 166 of the Internal Revenue Code.

the proper tax treatment of a bad debt reserve of a partnership when it transfers all of its assets to a corporation in exchange for the latter's stock in a transaction described in Section 351 of the Internal Revenue Code. Because a bad debt reserve represents anticipated future losses that have not in fact been sustained, the possibility exists, if adjustment is not made for the bad debt reserve, that the identical bad debt loss would be allowed twice—once to the partnership when it established the reserve and a second time to the corporation which will actually suffer the bad debt loss on the accounts receivable transferred.

Petitioners recognize the necessity for avoidance of a double deduction of the same bad debt loss (Br. 5–6, 20–31). They can do no less, for decisions of this Court extending over a period of more than four decades—the most recent of which was announced only last Term—make it clear that "the Code should not be interpreted to allow * * * 'the practical equivalent of double deduction,' * * * absent a clear declaration of intent by Congress." *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684. See *United States* v. *Ludey*, 274 U.S. 295, 301; *Burnet* v. *Aluminum Goods Co.*, 287 U.S. 544, 551; *Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 68.[6]

[6] The policy against the allowance of double deductions is reflected in various provisions of the Internal Revenue Code (Sections 164(e), 642(e), 642(g), 1311–1315, 1341(b)(3) and 7852(c)) and the Treasury Regulations (Sections 1.62–1(b), 1.161–1, 1.691(b)–1(b), 1.901–1(b)(2)(h) and 1.1016–6(a)) and has been the basis of decision in numerous lower court cases. See, *e.g.*, *Candy Bros. Mfg. Co.* v. *Commissioner*, 17 T. C. 298, 304, affirmed, 198 F. 2d 330 (C.A. 8); *Eljer Co.* v. *Commissioner*,

The dispute between the parties thus is not so much *whether* a double deduction is to be avoided, but *which* of several possible rules should be applied to avoid a double deduction. The Code does not speak explicitly to the point. The position of the Commissioner of Internal Revenue, which was approved by the court below but rejected by the Ninth Circuit in *Estate of Schmidt* v. *Commissioner,* 355 F.2d 111, is set out in Rev. Rul. 62–128, 1962–2 Cum. Bull. 139. That ruling provides that since the Section 351 transfer makes it clear that the transferor will not suffer the losses represented by the earlier deductions, the balance of the reserve should be restored to income pursuant to the so-called "tax benefit" rule. Under this rule, the recovery of an item—in this case the bad debt reserve—which has produced an income tax benefit in a prior year is to be added to income in the year of recovery. Consistently, the Commissioner would permit the corporation to which the accounts receivable are transferred to take an appropriate bad debt deduction in respect of the receivables transferred.

Petitioners contend, on the other hand, that the tax benefit rule does not apply here because the transferor did not collect the full face amount of the transferred accounts receivable, and that, in any event, its application is barred by Section 351 of the Code, which provides that gain or loss shall not be recognized if property is transferred by a partnership (or sole

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134 F. 2d 251, 254–255 (C.A. 3); *Edward Katzinger Co.* v. *Commissioner*, 44 B.T.A. 533, affirmed, 129 F. 2d 74 (C.A. 7); *Doylestown & Easton Motor Coach Co.*, v. *Commissioner*, 9 T.C. 846, 850; *Bush Terminal Buildings Co.* v. *Commissioner*, 7 T.C. 793, 816–817; *Gould Coupler Co.*, 5 B.T.A. 499, 518.

proprietorship) to a controlled corporation. Petitioners would solve the double deduction problem either by requiring that the partnership's reserve be carried over to the corporate transferee, or by reducing the basis of the accounts receivable by the amount of the reserve.

We will show first that this is a proper case in which to apply the tax benefit rule because, when the partnership terminated, there was no longer any need for maintenance of the reserve. This, we submit, is a sufficient recovery to warrant application of the tax benefit rule. We will then show that application of the rule is in no way inconsistent with the proscription of Section 351 against recognition of gain or loss. With regard to petitioners' proposed solutions to the double deduction problem, we contend that neither solution is prescribed in the Code. In the absence of a Code directive requiring a carryover or a reduction in basis, the Commissioner's solution must be upheld, because it is reasonable and not inconsistent with the statute.

THE COMMISSIONER PROPERLY APPLIED THE TAX BENEFIT RULE IN REQUIRING RESTORATION TO INCOME OF THE PARTNERSHIP'S BAD DEBT RESERVE UPON THE TRANSFER OF ITS ASSETS TO CONTROLLED CORPORATIONS

A. THE TAX BENEFIT RULE APPLIES WHEN A BAD DEBT RESERVE IS NO LONGER NEEDED, WHETHER OR NOT THERE HAS BEEN A CASH COLLECTION OF ACCOUNTS RECEIVABLE

It is a fundamental principle of federal income taxation that a recovery of an item which has produced an income tax benefit in a prior year is to be added to income in the year of recovery. See, *e.g., Alice Phelan*

Sullivan Corp. v. *United States,* 381 F. 2d 399, 401 (Ct. Cl.); *Merchants Nat. Bank* v. *Commissioner,* 199 F. 2d 657, 659 (C.A. 5); *Freihofer Baking Co.* v. *Commissioner,* 151 F. 2d 383, 386 (C.A. 3); *Union Trust Co. of Indianapolis* v. *Commissioner,* 111 F. 2d 60 (C.A. 7), certiorari denied, 311 U.S. 658; *Chicago, R.I. & P. Railway Co.* v. *Commissioner,* 47 F. 2d 990 (C.A. 7), certiorari denied, 284 U.S. 618; *Charleston & W. C. Ry. Co.* v. *Burnet,* 50 F. 2d 342 (C.A.D.C.). Although no provision of the Internal Revenue Code articulates the so-called tax benefit rule, it is engrained in the tax law and is recognized in Section 111, which prevents the restoration to income of "bad debts, prior taxes and delinquency amounts" to the extent that no tax benefit therefor has been allowed in a prior taxable year.[7] The rule rests on the notion that a taxpayer should not be permitted to retain the tax benefit of a deduction when later events demonstrate that he no longer is entitled to it. That the adjustment is made in a taxable year subsequent to the year in which the deduction is allowed is a consequence of the annual accounting system. See *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359.

Since a reserve for bad debts represents losses that are estimated will be sustained in subsequent taxable years, it is the accepted and longstanding general rule that any unabsorbed amounts in such a reserve must

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[7] Section 111 would apply, for example, to prevent application of the tax benefit rule upon recovery of a bad debt allowed as a deduction in a prior year, where the loss did not result in a reduction of taxes because the taxpayer's other expenses completely offset his income.

be restored to income when the reserve is found to be excessive or no longer necessary—that is, when it becomes clear that the taxpayer will not suffer some or all of the estimated losses as a result of the uncollectibility of accounts receivable. *Arcadia Savings and Loan Assn.* v. *Commissioner,* 300 F. 2d 247 (C.A. 9); *West Seattle National Bank of Seattle* v. *Commissioner,* 288 F. 2d 47 (C.A. 9); *S. Rossin & Sons* v. *Commissioner,* 113 F. 2d 652, 654 (C.A. 2); *Citizens Federal S. & L. Ass'n of Cleveland* v. *United States,* 290 F. 2d 932, 936 (Ct. Cl.). See also *Handelman* v. *Commissioner,* 36 T.C. 560; *Geyer, Cornell & Newell, Inc.* v. *Commissioner,* 6 T.C. 96, 100; and *C. Standlee Martin, Inc.* v. *Riddell,* 56–2 U.S.T.C., par. 9989 (S.D. Calif.).[8] These cases formed the basis for the Commissioner's ruling in 1962 that a reserve for bad debts must be restored to the income of a sole proprietorship or partnership upon the incorporation of its business, because, when the separate ownership of the business terminates, the taxpayer's need for a reserve also terminates. Rev. Rul. 62–128, 1962–2 Cum. Bull. 139.

In the first appellate decision to consider the question here presented, the Court of Appeals for the Ninth Circuit rejected the Commissioner's ruling. *Estate of Schmidt* v. *Commissioner,* 355 F. 2d 111. It did so despite its earlier recognition that it is a

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[8] Published rulings of the Commissioner have also applied this rule. For example, Rev. Rul. 57–482, 1957–2 Cum. Bull. 49, indicates that when a corporation sells its assets in a Section 337 liquidation (where gain or loss on the sale of property is not recognized), it realizes ordinary income to the extent of its reserve for bad debts.

"well established principle that additions to a reserve for bad debts previously deducted in computing taxable income must be included in taxable income when and to the extent that the reserve is no longer necessary." *Arcadia Savings and Loan Assn.* v. *Commissioner, supra,* p. 250. In *Arcadia,* the court had held that the tax benefit rule applied to require restoration of a bad debt reserve to income following a sale of substantially all of a corporation's assets, even though gain on the sale was not recognized under Section 337 of the Code.

The Ninth Circuit's rationale in *Schmidt,* upon which petitioners rely (Br. 31–34), was that although it was true that the taxpayer no longer needed the reserve, it was not true in an economic sense that he had "recovered" its value. 355 F. 2d at 113. As that court saw the matter, all that the taxpayer "recovered" in relation to the receivables transferred to the controlled corporation were stock certificates representing the net value (the face amount of the receivable less the reserve), rather than the face value, of the receivables (*Ibid.*) Therefore, the court concluded that the tax benefit rule did not apply. It found *Arcadia* and the other prior decisions distinguishable on the ground that the value of the reserves in those cases had been recovered through actual sales of receivables. *Id.,* p. 113, n. 7.

Apart from the fact that the Ninth Circuit was mistaken in its reading of *Arcadia*—the amount of the reserve there was not actually collected [9]—we submit

[9] Nor can *Arcadia* be explained away, as the Ninth Circuit suggested (355 F. 2d at 113, n. 7), on the ground that it in-

that the court erred in holding that the tax benefit rule does not apply to a non-recognition transaction under Section 351, as well as to such a transaction arising under Section 337. To limit application of the rule to cases in which there has been an economic recovery would frustrate its purpose, which is to insure that a taxpayer not retain the benefit of a deduction to which it is no longer entitled. Fulfillment of that purpose requires application of the rule, whether the lack of need for a bad debt reserve arises from a sale or collection of accounts receivable, or merely by reason of the termination of the existence of the owner of the receivables.[10]

In addition to failing to take account of the purpose of the tax benefit rule, the Ninth Circuit rested its decision in *Schmidt* on three faulty premises.

First, the court stated (355 F. 2d at 113, n. 6): "Surely, if the taxpayer had sold the receivables, for

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volved "a change in accounting methods." There is no indication in the *Arcadia* opinion that such a change was the basis for the decision.

[10] The court of appeals' characterization of the income realized in *Schmidt* as "fictitious income, never received by the taxpayer in fact" (355 F. 2d at 114), does not change the fact that the taxpayer no longer needed the reserve that had been created. Nor does it justify the court's refusal to restore the reserve to income, since the bad debt deduction which gave rise to the reserve could be characterized, under the court's economic analysis, as "fictitious expense, never sustained by the taxpayer in fact." This Court recently has cautioned against the resolution of income tax problems on the basis of "economic" analysis which assumes as its premise that what is sought to be taxed is "fictitious" income. *Commissioner* v. *Gordon*, 391 U.S. 83, 90, n. 5. While that admonition was given in a different context, it is equally well taken here.

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cash, for their net value, he would not have realized income in the amount of the reserve. Yet, just as surely, he would no longer 'need' the reserve." This observation, which the court presumably made to support its conclusion that the tax benefit rule may be invoked only where there is an economic recovery of a bad debt reserve, is, we submit, unfounded. When a taxpayer on the reserve method sells accounts receivable for their net value, he must nevertheless restore the reserve to income. Restoration is required because the loss he has sustained is not a bad debt loss, but rather a loss from the sale of property. *Levy* v. *Commissioner,* 46 B.T.A. 423, affirmed, 131 F. 2d 544 (C.A. 2), certiorari denied, 318 U.S. 780; *Benedum* v. *Granger,* 180 F. 2d 564 (C.A. 3); *Reed* v. *Commissioner,* 45 B.T.A. 1130, affirmed, 129 F. 2d 908 (C.A. 4); and *Von Hoffman Corp.* v. *Commissioner,* 253 F. 2d 828 (C.A. 8). The proper analysis of the transaction where accounts receivable are sold for their net value by a reserve method taxpayer is to restore the reserve to his income and accord him a loss on the sale of property.[11] That this loss (face value less amount realized) equals the amount of the restoration to income does not militate against the basic principle that the reserve must be restored to income when it is no longer needed, irrespective of whether there has been an economic recovery.

[11] The court of appeals' conclusion in *Schmidt* (355 F. 2d, at 114) that "where accounts receivable are sold for cash for less than face value, the difference being the amount of the reserve, the taxpayer does not then 'realize' a loss," seems obviously incorrect.

Second, there is no basis for the Ninth Circuit's assumption (355 F. 2d, at 113) that the tax benefit rule has no application where a taxpayer receives only "pieces of paper—stock certificates"—in exchange for the accounts receivable transferred. If a corporation liquidates and distributes its assets, including accounts receivable, to its shareholders in kind, the rule requires restoration of the reserve to the corporation's income, even though gain or loss is not recognized on the liquidation pursuant to Section 336 of the Code. This much petitioners concede (Br. 32) despite the fact that the corporation's "recovery" consists only of the stock certificates which are turned in by its shareholders.

Third, the court erred in refusing to consider the effect of its holding upon the corporate transferee in *Schmidt*. It stated (355 F. 2d at 114): "We do not pass upon the right of the corporation, at the commencement of its business, to set up the same reserve as an offset to the receivables entered upon its books. The only question before us is the liability of the individual taxpayer." This refusal, although couched in traditional terms of judicial restraint, cannot be squared with this Court's recent reaffirmance of the principle that "the Code should not be interpreted to allow * * * 'the practical equivalent of double deduction,' * * *, absent a clear declaration of intent by Congress." *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684. See pp. 5–6, *supra*. Whatever doubts may have existed as to the viability of this principle when *Schmidt* was decided in 1966 were resolved by *Skelly*

Oil in 1969. In approaching the question whether the tax benefit rule should have been applied in *Schmidt*, the court should have been mindful of the possibility that its decision could lead to the "practical equivalent of double deduction' * * *."

There is, in sum, nothing in the Ninth Circuit's opinion that justifies its failure to invoke the tax benefit rule. Petitioners advance only one additional argument in support of that court's economic analysis. They rely (Br. 34) on Treasury Regulations, Section 1.111-1(a)(2), which provides: "Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 111 items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. * * *" Petitioners contend that because the Regulation includes examples of what the Ninth Circuit characterized as "economic" recoveries (355 F. 2d at 113), only such recoveries can come within the tax benefit rule. This is not correct. The use of the words "such as" in the Regulation makes it clear enough that what are referred to as examples of recoveries are only examples. Moreover, as we have noted (p. 13, *supra*), petitioners do not dispute that a recovery occurs when a corporation distributes its accounts receivable in liquidation, even though it receives only its shareholders' stock certificates in return. The recovery here is no different than that of a liquidating corporation and is sufficient to warrant application of the tax benefit rule.[12]

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[12] Petitioners also contend (Br. 17) that the tax benefit rule does not apply here because "the taxpayer's need [for the bad

B. SECTION 351 OF THE CODE DOES NOT BAR APPLICATION OF THE TAX BENEFIT RULE

Section 351(a) of the Code provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation * * * by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control * * * of the corporation. * * *" The non-recognition rule of Section 351 is an exception to the general rule of Section 1002 that the entire amount of gain or loss (determined under Section 1001) resulting from the sale or exchange of property is to be recognized, with immediate tax consequences. If a transfer qualifies under Section 351, the basis of the property given up by the transferor becomes the basis of the stock received in the exchange. Section 358. Thus, the practical effect of Section 351 is to defer the recognition of gain or loss until the ultimate sale or disposition of the corporate stock by the transferor. See *Portland Oil Co.* v. *Commissioner,* 109 F. 2d 479, 488 (C.A. 1).

Petitioners' major contention is that the non-recognition rule of Section 351 precludes the application of the tax benefit rule in the circumstances of this case. Pointing to the legislative history of Section 351 (Br. 7–12), petitioners maintain that the policy of the pro-

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debt reserve] continues in a Section 351 transfer." This was not the rationale of the Ninth Circuit. That court agreed (355 F. 2d at 113) that the partnership's need terminated at the time of the transfer. In all events, petitioners' contention turns on the interpretation of Section 351 and whether the partnership's reserve may be carried over to the transferee corporations, matters with which we deal below, pp. 19–20, 26, n. 24, *infra*.

vision requires that the partnership's bad debt reserve not be restored to income, because a Section 351 transfer involves nothing more than a change in the form of ownership of an existing business.

The fallacy in petitioners' argument is that the language of Section 351 does not read as petitioners would have it read. It provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation * * * solely in exchange for stock or securities * * *." But the Commissioner is not here seeking to tax "gain or loss." "Gain or loss" is a statutory term of art and can arise only "on the sale or exchange of property" as provided in Section 1002. A reserve for bad debts is not property, however. Nor is it capable of being sold or exchanged. "A reserve consists of entries upon books of account. It is neither an asset nor a liability. It has no existence except upon the books, and, unlike an asset or a liability, it can not be transferred to any other entity." *Geyer, Cornell & Newell, Inc.* v. *Commissioner,* 6 T.C. 96, 100. See also *J. E. Hawes Corp.* v. *Commissioner,* 44 T.C. 705, 707–708; *Bird Management, Inc.* v. *Commissioner,* 48 T.C. 586, 594–597; Finney and Miller, *Principles of Accounting, Intermediate* (4th ed. 1953), p. 534; Paton, *Advanced Accounting* (1947 ed.), p. 598. It follows—since a bad debt reserve is not "property" and cannot be transferred—that restoration of the reserve to income cannot result in "gain or loss." Thus, Rev. Rul. 62–128, 1962–2 Cum. Bull. 139, which requires restoration of the reserve when accounts receivable are transferred in a Section 351 transaction, does not contravene the restric-

tion of that provision against recognition of "gain or loss." [13]

Petitioners are in substance asking that the Court construe Section 351 as if it called for "non-recognition of gain, loss or income" (Br. 11), even though the statute provides only that "gain or loss" should not be recognized.[14] The legislative history upon which petitioners rely (Br. 7–12) to support their argument does not go beyond the language of the statute, however. That history shows only that Congress intended to insulate "gain or loss" from recognition in a Section 351 transfer. It is true that Congress could have legislated further and provided that income generally, not merely "gain or loss," should go unrecognized under Section 351, or that reserves should go over to the transferee of the assets, without immediate tax consequences. But Congress did not legislate further, and the courts should not extend the statute beyond its plain terms. As this Court has observed, "It is our judicial function to apply statutes on the basis of what Congress has written, not what Congress might have written." *United States* v. *Great Northern Railway Co.*, 343 U.S. 562, 575.

[13] Treasury Regulations, Section 1.453–9(c)(2), which provides that gain or loss shall not be recognized upon the transfer of installment obligations in a Section 351 transaction is not inconsistent with Rev. Rul. 62–128, *supra*, as petitioners contend (Br. 11–12). Unlike a reserve for bad debts, installment obligations are property and are capable of being transferred, and a taxpayer, therefore, can realize gain or loss on their disposition.

[14] In apparent contradiction, petitioners recognize (Br. 21) that "gain" as it appears in the term "gain or loss" is not coextensive with the concept of income.

None of petitioners' remaining arguments in support of their interpretation of Section 351 have merit. Their contention (Br. 17–18), that it would be "paradoxical" to restore the reserve to income in an otherwise tax-free transaction under Section 351, suggests that the reserve would not be so restored in a taxable transaction. As we have previously shown (pp. 11–12, *supra*), however, restoration of the reserve would be required in either event, for application of the tax benefit rule does not turn on whether a transaction is taxable, but simply on whether the need for the reserve has terminated. While petitioners are correct in pointing out that a taxable sale of receivables would result in no net income, that result obtains not because the tax benefit rule is inapplicable, but because the loss realized on the sale (the excess of the face amount of the receivables over net value) would offset the amount restored to income. When petitioners' partnership transferred its accounts receivable to the controlled corporations, petitioners realized a loss, just as they would have in a taxable transaction. Petitioners were barred from recognizing that loss, however, by the non-recognition rule of Section 351. There is thus nothing "paradoxical" in applying the tax benefit rule in an otherwise tax-free situation.

As the Fifth Circuit recognized below (R. 19), the paradox would arise if the rule were not applied, since petitioners would then in effect be recognizing the loss on transfer of the receivables which Section 351 says may not be recognized—along with any gains which

inhered in the overall transaction. In effect, petitioners are here seeking recognition of their losses, while their gains go unrecognized, which is not what Congress provided. Section 351 is equally applicable to gains *and* losses.

The contentions that a taxpayer's need for a bad debt reserve continues in a Section 351 transaction (Br. 17) and that application of Rev. Rul. 62-128, *supra,* would distort the income of both the transferor and the transferee in the transaction (Br. 18-19) assume the very point which is an issue. If, as we contend (pp. 16-17, *supra*), Congress did not legislate as broad a non-recognition rule as it might have when it enacted Section 351, the transferor and transferee cannot be considered the same taxpaying entity with respect to those items which do not constitute property or are not capable of being transferred—including a reserve for bad debts. This being the case, the "continuation of business" theory cannot apply with respect to such items. Absent this theory, there would be no continuing need for the reserve, because, for purposes of determining the adequacy of the reserve, the transferor would not be deemed a continuing entity.[15] There would likewise be no distortion of the income of either the transferor or the transferee, since the former's income would reflect all bad losses actually sustained up to the time of the transfer, and

[15] Once this is recognized, it becomes irrelevant—notwithstanding petitioners' contentions to the contrary (Br. 12, 17)—that the partnership's reserve, determined on the assumption that the partnership would continue to exist, was reasonable.

the latter's would reflect all such losses actually sustained thereafter.[16]

That the Commissioner first ruled on the question here presented in 1962 (Rev. Rul. 62–128, *supra*) does not warrant the inference drawn by petitioners (Br. 13, 26) that prior to 1962 he agreed with their proposed interpretation of Section 351. Nor can this inference be drawn from the fact that the question was first litigated in 1966 in *Estate of Schmidt* v. *Commissioner, supra,* as petitioners suggest (Br. 15). We are advised by the Internal Revenue Service that during the pre-ruling period the problem was handled on an *ad hoc* basis by revenue agents in the field. The ruling, which we believe to be completely consistent with Section 351, was designed to provide a uniform rule for all taxpayers and one which would, in all events, effectively prevent a double deduction. In these circumstances, there is no basis for interpreting the Commissioner's failure to rule before 1962 as indicative of his acquiescence in a rule contrary to that which we urge here.

C. THE EXISTING FRAMEWORK OF THE CODE IS NOT READILY ADAPTABLE TO EITHER OF PETITIONERS' PROPOSED SOLUTIONS TO THE DOUBLE DEDUCTION PROBLEM

Recognizing that a double deduction might result if the tax benefit rule does not apply (Br. 25, 29), petitioners argue that this problem can be avoided by requiring that a partnership's reserve for bad debts be carried over to a corporate transferee, or by recog-

[16] As noted above (p. 6, *supra*), the Commissioner would allow the transferee corporation to deduct bad debt losses on the receivables transferred to it.

nizing that the reserve reduces the basis for the receivables in the hands of the partnership. The first alternative would preclude a corporate transferee from claiming the same bad debt deduction allowed to the partnership, since the reserve in respect of the transferred receivables would be reflected on the corporation's books without the allowance of any additional deduction. The second alternative would accomplish the same purpose, since the corporate transferee would take the partnership's basis for the receivables pursuant to Section 362. While each proposed solution thus would prevent both parties to a Section 351 transfer from claiming the same deduction, neither solution is in line with prior judicial authority or with the technical requirements of the Code.

1. Carryover of reserve for bad debts

Section 381 of the Code is the basic statute dealing with the carryover of certain specified "items" (Section 381(a)) from one taxpayer to another. By its terms, it provides for carryovers only in cases involving intercorporate transfers of property—certain liquidations of corporate subsidiaries (Section 381(a)(1)) and certain corporate reorganizations described in Section 368 (Section 381(a)(2)).[17] It does not provide for the carryover of "items" in a transaction described in Section 351.

[17] These are the reorganizations described in Section 368(a)(1)(A), (C), (D) and (F). In the case of Section 368(a)(1)(D) reorganizations, the carryover rules are applicable only if the requirements of Section 354(b)(1)(A) and (B) are satisfied.

Among the items which are to be carried over by an acquiring corporation subject to Section 381 are the methods of accounting of the transferor corporation, including, where the transferor is using the reserve method of accounting for bad debts, its reserve for bad debts. See Section 381(c)(4); Treasury Regulations, Section 1.381(c)(4)-1(a)(1)(ii). Petitioners maintain that the rule of Section 381(c)(4) should apply here despite "the lack of specific statutory direction" (Br. 24).

To support this contention, petitioners again contend that the transfer from partnership to corporation constitutes nothing more than a mere change in the form of ownership of a business. They point out that this theory also underlies Section 361, which provides for nonrecognition of "gain or loss" upon the transfer of property from one corporation to another in a corporate reorganization; and conclude from this that bad debt reserves should be carried in corporate organizations as well as corporate reorganizations.

(1) Petitioners' conclusion ignores the well-settled rule that the transferee corporation in a Section 351 exchange is a new taxpayer and is entitled to adopt its own taxable year and its own accounting methods, including, in this instance, the specific charge off method for reporting bad debts.[18] See, *e.g.*, *Ezo*

[18] Petitioners argue to the contrary (Br. 25) in reliance on Treasury Regulations, Section 1.166-1(b)(1). While we do not agree that the Commissioner could prevent a corporate transferee from using the specific charge off method merely because the transferor used the reserve method, nothing in the cited

Products Co. v. *Commissioner*, 37 T.C. 385, 393–394; *Dearborn Gage Co.* v. *Commissioner*, 48 T.C. 190, 201, and cases cited therein. Indeed, the transferee is considered to be a new taxpayer with respect to depreciable assets received by it in the exchange and is therefore not entitled to use the accelerated methods of depreciation that are available only to original users of property under Sections 167 (b) and (c). Rev. Rul. 67–286, 1967–2 Cum. Bull. 101.

Finally, to the extent that Congress has permitted certain carryovers of tax attributes in Section 351 transactions, it has carefully delineated the carryovers. See Sections 47(b)(3), 1245(b)(3), and 1250(d)(3).[19] Except as to these specific provisions, Congress has apparently seen fit to limit the carryover of a bad debt reserve to certain types of corporate *reorganizations* and not the corporate *organization* encompassed in Section 351.[20] For the

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Regulation empowers the Commissioner to insist on a carryover of the transferor's reserve in order to avoid a double deduction.

[19] Contrary to petitioners' contention (Br. 30), the enactment of these provisions is not indicative of any Congressional policy to treat Section 351 transfers and reorganizations in a "similar * * * fashion." The legislative history of these specific enactments dealing with the investment credit and the recapture of depreciation reveals no such purpose. See H. Rep. No. 1447, 87th Cong., 2d Sess., pp. A15–A16, A109–A110; S. Rep. No. 1881, 87th Cong., 2d Sess., pp. 152, 282–283; H. Rep. No. 749, 88th Cong., 1st Sess., p. 105; S. Rep. No. 830, 88th Cong., 2d Sess., pp. 135–136.

[20] *Calavo, Inc.* v. *Commissioner*, 304 F. 2d 650 (C.A. 9), and *Home Savings and Loan Association* v. *United States*, 223 F. Supp. 134 (S.D. Calif.), relied upon by petitioners (Br. 22, n. 22), are not in point. Each of those cases involved transac-

only carryover aspect of Section 351, as set forth in that provision, is the requirement that the controlled corporation carry over the transferor's basis in the property transferred. Sections 351(d)(2) and 362, Appendix, *infra*, pp. 34–35.

Accordingly, whatever abstract merit a carryover of the bad debt reserve in the instant case might have, it is plain, at the very least, that Congress has not authorized such a carryover. Under these circumstances, the existing structure of the Code does not support the bad debt reserve carryover for which petitioners contend. As Judge Raum explained in *Schuster* v. *Commissioner,* 50 T.C. 98, 102, which approved the Commissioner's rule as applied in the instant case [21]—

> The Code is a highly complex instrument, and it would be inappropriate, in order to reach a seemingly equitable result, to proceed upon theories that depart from an established course of decision or that do violence to the statute. In a field that is governed by so specific a statutory scheme relating to nonrecognizable transfers, any logical departure therefrom must be based on specific legislative modifications. The remedy is one that must be provided by Congress, rather than through a judicial reconstruction of a complex law. [Footnote omitted.]

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tions—*Calavo*, a Section 332 liquidation, and *Home Savings*, a Section 368(a)(1)(A) reorganization—to which the carryover rules of Section 381 specifically apply.

[21] The Tax Court has adhered to its position in *Hutton* v. *Commissioner*, 53 T.C. 37.

This Court similarly observed in *Commissioner* v. *Gordon*, 391 U.S. 83, 91–92, in construing another technical provision of Subchapter C, that "The requirements of the sections are detailed and specific, and must be applied with precision." Since the terms of the Code do not expressly require the carryover of a bad debt reserve from a partnership to a corporation, the Commissioner's rule requiring a restoration of the reserve to income is more closely in harmony with the Code's highly technical structure.[22]

(2) Given the existing framework of the Code, petitioners' contention that the Commissioner's rule yield to their carryover solution to the double deduction problem is unpersuasive. Not only do the highly articulated provisions of the Code point toward the correctness of the Commissioner's rule, but there is, in addition, no theoretical justification for broadly

[22] Petitioners rely (Br. 26–28) on the reasoning of the dissenting opinion in *Schuster* (50 T.C. at 103–104) to the effect that the legislative history of Section 381 indicates that it was not meant to be exclusive on the subject of carryovers of tax attributes. However, it should be noted that the Committee Report references deal only with carryovers from predecessor to successor corporations and do not expressly refer to carryovers from partnerships to corporations in a Section 351 exchange. While petitioners are correct (Br. 27) in observing that prior to the enactment of Section 381, the courts, in certain instances, permitted carryovers, those cases all involved intercorporate transfers. Furthermore, the results were by no means uniform. Compare, *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382, with *Helvering* v. *Metro. Edison Co.*, 306 U.S. 522. Significantly, petitioners do not advance any cogent argument for returning to the era of court-made law in this highly technical area, given the precise and detailed manner in which Congress has established the ground rules in Section 381.

analogizing a Section 351 transfer to a corporate reorganization.

All of the corporate reorganizations to which the carryover provisions of Section 381 apply involve business amalgamations accomplished either by statutory merger or consolidation (Section 368(a)(1)(A)) or by a transfer of substantially all of the assets of the transferor corporation (Section 368(a)(1)(C), (D), and (F)).[23] This is likewise true of the corporate liquidations to which the Section 381 rules apply. The carryover rules can apply only in the case of complete liquidations of subsidiaries under Section 332. A Section 351 transaction, on the other hand, may involve the transfer of a single asset. It is thus entirely reasonable for Congress not to have carried the continuation of business theory as far in the corporate organization area as it did in the area of corporate reorganizations.[24]

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[23] The Section 368(a)(1)(C) reorganization requires a transfer of "substantially all of the properties" of the transferor. Similarly, the non-divisive Section 368(a)(1)(D) reorganization, by operation of Section 354(b)(1)(A), requires a transfer of "substantially all of the assets" of the transferor. And, the Section 368(a)(1)(F) reorganization—"a mere change in identity, form, or place of organization * * *"—presupposes the transfer of an entire business organization.

[24] Petitioners ask rhetorically (Br. 20) how the need for a bad debt reserve can terminate in a Section 351 transaction, so as to justify invocation of the tax benefit rule, while the need would not terminate in an otherwise comparable corporate reorganization situation. The answer to this question is that in enacting Section 381, Congress determined that the need continues in the latter situation. Its failure to include Section 351 transactions within the coverage of Section 381 indicates that it made no such determination with respect to corporate organizations.

Further reason for the Congressional decision may be found in the fact that although corporate reorganizations, by definition, involve only corporations, a Section 351 transfer may involve a non-corporate party. The distinction between individual and corporate taxpayers is manifest throughout the Code. First, graduated tax rates are imposed upon individuals by Section 1, while corporations are subject to the normal tax and surtax under Section 11.[25] In addition, the assumption of corporate form triggers an entire body of detailed provisions (Sections 301–318, 332–337, 354–382) and presents a variety of benefits and elective options (*e.g.,* Sections 243–246, 421–425 and 1371–1378) and potential liabilities (Sections 341, 531–537, 541–547), none of which apply to non-corporate taxpayers. All of this suggests that it would be inappropriate to draw a broad analogy between the corporate organization and reorganization provisions of the Code.[26]

(3) Moreover, although a carryover of a bad debt reserve would prevent the deduction of the same bad

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[25] The Fifth Circuit regarded this difference in tax rates as significant (R. 19) in upholding the Commissioner's rule requiring restoration of the bad debt reserve to income.

[26] It would likewise be inappropriate to draw such a broad analogy on the basis of this Court's decision in *Helvering* v. *Cement Investors, Inc.*, 316 U.S. 527. The Court there noted (p. 534) the "close relationship" between the organization and reorganization provisions, in holding that the former, rather than the latter, were applicable in the circumstances presented. But the Court also recognized the distinction we have discussed above. It observed (p. 533) that "[w]hile the 'reorganization' provisions are restricted to inter-corporate transactions § [351] is not so confined * * *."

debt loss by the transferror and transferee in a Section 351 transaction, it would result in a double benefit for the transferor. This double benefit arises by reason of the operation of Section 358. Under that provision, the transferor in a Section 351 transaction receives a tax basis in the corporate stock he acquires equal to the basis of the property he transfers, here the face amount of the accounts receivable.[27] On the other hand, the value of the stock he receives would be equal to the net value of the receivables (face amount less reserve). Accordingly, the tax benefit which resulted when the reserve was established is perpetuated in an inflated basis for the corporate stock received. Unless the reserve is taken into income at the time of the Section 351 transfer, the transferor could ultimately diminish his income twice: once when he established the reserve and obtained a bad debt deduction, and a second time when he disposes of the stock and is permitted to use its inflated basis in computing gain or loss.

2. Reduction in basis of accounts receivable

Presumably in recognition of the fact that their reserve carryover proposal solves one double deduction problem but creates another, petitioners contend (Br. 30–31) that the basis of accounts receivable in the hands of a taxpayer on the reserve method should be reduced at the time the taxpayer takes a deduction that increases the reserve, rather than at the later

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[27] As we explained below (pp. 29–30, *infra*), there is no statutory authority whereby the basis of the receivables transferred can be adjusted downward to reflect the bad debt reserve.

time when the reserve is decreased to reflect the worthlessness of a specific account. But the Code no more provides for a basis reduction prior to the actual worthlessness of an account than it does for a carryover.

Under Section 1016(a)(1), adjustments to basis may be made "for expenditures, receipts, losses, or other items, properly chargeable to capital account * * *." The deduction that increases the reserve does not come within any of the specified categories. It cannot be considered a loss because, at any given time, the reserve reflects only losses which it is estimated will be sustained in the future. Nor can it be considered an "other item" chargeable to capital account, since it reflects a provisional estimate rather than a fixed and final determination and, as a matter of accounting technique, is not chargeable against accounts receivable.[28] See *Accountants' Handbook* (4th ed. 1957), Sec. 11.24; Karrenbrock and Simons, *Intermediate Accounting* (2d ed. 1953), pp. 87, 184.

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[28] Petitioners point out that a taxpayer on the specific charge off method may reduce his basis in accounts receivable at the time he becomes entitled to a bad debt deduction—when a specific account becomes worthless. They maintain that a reserve method taxpayer should be entitled to reduce basis at the time he becomes entitled to a bad debt deduction—when he increases the reserve in advance of actual worthlessness—and that not to allow a basis reduction at that time is discriminatory. This argument ignores the language of Section 1016(a)(1) and the rationale of the reserve method itself. There is no discrimination between specific charge off and reserve method taxpayers. Both are entitled to a basis adjustment when a loss is in fact sustained.

Finally, we deal with the argument that a reserve for bad debts should be treated as reducing basis on the theory that it is like a reserve for depreciation which does reduce basis. The reduction in basis for a depreciation reserve is not made under Section 1016 (a)(1), however, but is specifically provided for in Section 1016(a)(2). See also *West Seattle National Bank of Seattle* v. *Commissioner,* 288 F. 2d 47, 49 (C.A. 9); *National Bank of Commerce of Seattle* v. *Commissioner,* 115 F. 2d 875, 877–878 (C.A. 9). No comparable specific provision prescribes a basis adjustment for a bad debt reserve.

D. SINCE THE COMMISSIONER'S SOLUTION TO THE DOUBLE DEDUCTION PROBLEM IS REASONABLE, IT MUST BE UPHELD EVEN IF HE MIGHT HAVE SOLVED THE PROBLEM BY OTHER MEANS

Under Section 7805(a) of the Code, the Commissioner is empowered to "prescribe all needful rules and regulations for the enforcement of this title * * *." The Commissioner exercised the discretion confided to him thereunder in Rev. Rul. 62–128, *supra.* There he prescribed a uniform rule for all taxpayers and one which would insure against the possibility of a double deduction for the same bad debt loss.

As we have shown, the Commissioner's rule requiring restoration of the reserve to income in the circumstances of this case is fully consistent with all pertinent statutory provisions. That, we submit, should be the end of the matter. For even if the Commissioner could properly have resolved the double deduction problem by other means, it was not error for him not to have done so. Petitioners maintain that the

Commissioner could have required a reserve carry-over or a reduction in basis of accounts receivable under Sections 351, 381 and 1016. In addition, petitioners suggest (Br. 29) that the Commissioner might have acted under Section 446 (relating to methods of accounting) or Section 482 (relating to allocation of income and deductions among taxpayers). Whatever the merits of these alternative solutions, the Commissioner has chosen to restore the reserve to income—a result firmly grounded upon the well-settled tax benefit rule. Under these circumstances, it is of no significance that there may be alternative methods to deal with the problem. As this Court observed in *United States* v. *Correll,* 389 U.S. 299, 306–307—

> Alternatives to the Commissioner's * * * rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. 26 U.S.C. § 7805(a). * * *

CONCLUSION

For the reasons stated, it is respectfully submitted that the judgments of the court of appeals should be affirmed.

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MARCH 1970.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly worthless debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially worthless debts.*—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Reserve for Bad Debts.*—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

* * * * *

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) *General Rule.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) *Receipt of Property.*—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) *Special Rule.*—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

(d) *Cross References.*—

(1) For special rule where another party to the exchange assumes a liability, or acquires property subject to a liability, see section 357.

(2) For the basis of stock, securities, or property received in an exchange to which this section applies, see sections 358 and 362.

(3) For special rule in the case of an exchange described in this section but which results in a gift, see section 2501 and following.

(4) For special rule in the case of an exchange described in this section but which has the effect of the payment of compensation by the corporation or by a transferor, see section 61(a)(1).

SEC. 362. BASIS TO CORPORATIONS.

(a) *Property Acquired by Issuance of Stock or as Paid-In Surplus.*—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

* * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

SEC. 1.166-4. RESERVE FOR BAD DEBTS.

(a) *Allowance of deduction.*—A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) *Reasonableness of addition to reserve*—(1) *Relevant factors.*—What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.*—In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

(c) *Statement required.*—A taxpayer using the reserve method shall file with his return a statement showing—

(1) The volume of his charge sales or other business transactions for the taxable year and the percentage of the reserve to such amount;

(2) The total amount of notes and accounts receivable at the beginning and close of the taxable year;

(3) The amount of the debts which have become wholly or partially worthless and have been charged against the reserve account; and

(4) The computation of the addition to the reserve for bad debts.

(d) *Special rules applicable to certain banking organizations.*—For special rules for the addition to the bad debt reserves of certain mutual savings banks, domestic building and loan associations, and cooperative banks, see §§ 1.593-1 through 1.593-11.

U.S. GOVERNMENT PRINTING OFFICE: 1970.